Gerhard Fink and Peter Haiss

# Central European Financial Markets from an EU Perspective. Review of the Commission (1998) Progress Report on Enlargement

Paper

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GERHARD FINK/PETER R.HAISS

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**Review of the Commission (1998) Progress Report on Enlargement**

Juni 99

# Research Institute for European Affairs

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# Central European Financial Markets from an EU perspective, Review of the Commission (1998) Progress Report on Enlargement

*Gerhard Fink/Peter R.Haiss*

# Central European Financial Markets from an EU perspective

## Refiew of the Commission (1998) Progress Report on Enlargement [1]

*Gerhard Fink/Peter R.Haiss*

### Abstract

In its November 1998 Progress Report, the Commission of the European Union reviewed the progress of each Central and East European applicant state (CE-10)[1] towards accession. This paper summarises the Commissions comprehensive report on the respective countries′ financial services sector, which cuts across several economic and acquis criteria: the existence of a functionning market economy, including that the financial sector is sufficiently developed to channel savings towards productive investment; the capacity to withstand competitive pressure and market forces in the medium term, including the availability of a sufficient amount of capital at an appropriate cost; and the ability to take on the obligations of membership in the medium term, including the transposition and application of the acquis communautaire, the EUs established body of law, and the aims of economic and monetary union (capital movements, national bank status and financing, relations of the public sector with financial institutions).

In the analysis of the financial services' matters, two issues stick out. Firstly, there is at times an interesting diversity of views between a country's detailed analysis following the outlined criteria and the country-specific conclusions and recommendations. Thus, while the Commission shows a committment towards advocating EU enlargement as outlined in the (1997) Agenda 2000 framework (e.g. a separation in certain round one and round two countries), a true and fair sectoral view can only be derived from a cross-sectional analysis of the detailed material collected by the Commission (1998). Secondly, the financial sector and/or its regulatory and supervisory framework remains a major reform priority for all CE-10 accession countries and therefore can be regarded as a stumbling stone for EU membership. Thirly by analysing the Commissions (1998) country-by-country statements on financial sector issues, the following generalisations can be derived: the currently low and fragile level of financial intermediation hampers the accession countrie economic growth; corporate governance of and through the financial sector does not yet work in the CE-10; the type, maturity and magnitude of FDI in the financial sector matters for economic transition. We therefore suggest that ben

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[1] Note: The opinions expressed are the authors′ personal views and do not necessarily reflect those of institutions to which the authors are affiliated. An earlier version of the paper was prented at the ASSA/American Association Convention, Jan. 1999, New York.

[2] Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. While the Commission (1998) progress report also refers to Cyprus, Malta and Turkey, those countries are not included here.

chmarking the accession countries' financial sector for EU membership should concentrate more on these major issues.

**Keywords:** EU-enlargement, transition economies, financial sector reform, financial intermediation, corporate governance, foreign direct investment

**JEL Classification:** G21, G28, P43, P52

# Central European Financial Markets from an EU perspective

## Review of the Commission (1998) Progress Report on Enlargement

Gerhard Fink and Peter Haiss[2]

## 1. Introduction

For the ten formerly communist Central European countries (CE-10)[3] that already signed Association Agreements with the European Union, the state of the financial services industry is - or at least should be - of major priority in their preparation for EU membership. This is proven by the broad room devoted to the financial services sector, banking in particular, by the Commission in its 1998 assessment of the CE-10 membership capacity. In the following, Central European financial markets are described from the perspective of the EU as depicted in the 1998 progress report.[4] Firstly, the criteria as applied by the Commission are explained. Secondly, various statements made in several different sections of the Commission (1998) report about the respective countries` financial services sector are summarized on a country by country basis. Thirdly, conclusions on the general standing of the financial services sector in the CE-10 according to the Commission (1998) opinion, on the tone of the opinion and the approach of the Commission are taken.

## 2. Membership criteria of specific relevance to the financial sector

In its assessment, the Commission has to apply the criteria established at the Copenhagen European Council of June 1993: political, economic (functioning market economy; capacity to cope with competitive pressures and market forces within the Union in the medium term) and the "acquis" conditions (capacity to adopt the acquis and other obligations of membership,

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[2] Note: The opinions expressed are the authors' personal views and do not necessarily reflect those of institutions to which the authors are affiliated. An earlier version was presented at the joint American Social Sciences Association / American Economic Association Convention, January 1999, New York.

[3] Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

[4] The emphasis here is on financial markets in the applicant countries as seen by the Commission (1998). Dvorsky, Backé and Radzyner (1998) provide a review from a central bank perspective, but do not assess the Commission's country assessments; see p. 74.

including aims of EMU, internal market without frontiers, judicial and administrative capacity; Commission 1997). As one of the key channels for efficient allocation of resources, the degree to which the financial services sector meets these membership conditions plays a pivotal role:

The existence of a functioning market economy:

* equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalised;
* significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;
* the legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;
* marcroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts;
* broad consensus about the essentials of economic policy;
* the financial sector is sufficiently well developed to channel savings towards productive investment; (so far Commission 1998, Composite Paper).
* at present the Commission gives an assessment in perspective, not whether the applicant countries actually meet the requirements, but whether there is a good chance that they will meet, if sufficient efforts are undertaken.

The capacity to withstand competitive pressure and market forces within the Union in the medium term:

* the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability;
* a sufficient amount, at an appropriate cost, of human and physical capital, including infrastructure, education and research, and future developments in this field;
* the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.;
* the degree and the pace of trade integration a country achieves with the Union before enlargement. This applies both to the volume and the nature of goods already traded with member states;
* the proportion of small firms, partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust;

* in addition, some leeway is applied in mentioning the time lag between the implementation and the impact of economic policy and that the track record is very important in the evaluation.

In addition, the <u>ability to take on the obligations of membership and the acquis</u>, including the adherence to the aims of political, economic and monetary union is applied as criterion, i.e.
* the adoption of specific parts of community legislation on EMU to enable candidate countries to participate in EMU upon accession without adopting the euro, namely:

- completion of the orderly liberalisation of capital movements;
- prohibition of any direct public sector financing by the central bank and of privileged access of the public sector to financial institutions;
- alignment of the national central bank status with the Maastricht Treaty, including independence of the monetary authorities and the respect of the price stability goal.

* internal market without frontiers (free movement of goods, capital, services, persons)
* adoption of the acquis, the secondary legislation and the policies of the Union;
* administrative and judicial capacity to apply the acquis.

(This synopsis was derived from a larger section in the Commission Report 1998, Composite Paper).

**3. The applicant countries` financial sector in the Commission 1998 opinion**

According to the Agenda 2000 (Commission 1997), six countries met the economic and acquis criteria in the medium term: Hungary, Poland, the Czech Republic, Slovenia, Estonia and Slovakia. Broadly speaking, the Commission now finds in its (1998) progress report evaluation that, given certain conditions are met, five countries (Czechia, Estonia, Hugary, Poland and Slovenia) can be regarded as functioning market economies, even if in all these countries some important features, such as financial markes have to mature. Including Slovakia, these six countries should be able to cope with competitive pressure and market forces within the Union in the medium term - if and only if they are making sufficient and sustaned progress. An example of the original wording used by the Commission reads as: "provided this country vigorously implements its programme of reform". Hungary and Poland have continued to improve since the (1997) Agenda 2000 evaluation, while Czechia and Slovenia lost some ground as they have not shown a sustained political commitment to market reforms. Slovakia suffers from too much state intervention. Latvia, Lithuania and Bulgaria made substantial progress, Romania deteriorated. Looking at the fate of the financial services sector (banking, capital markets, insurance) in the respective countries in more detail, however, provides a quite comprehensive picture (Annex, Table 1). For all ten countries, the Commission labels the financial services sector and/or its regulation as major reform priority, i.e. as stumbling block for accession.

**Summaries of the Commission Reports (1998) on financial sector issues**

The following country cases are a text composition to reflect as best effort the Commission`s views in content, tone and writing style, using the wording and phrases as the Commission does, as this style is a message in itself. We have put together and summarised dispersed information contained in different sections of the Commission Report (1998). The relatively large space devoted to the screening of the financial sector and recurring reference to the financial sector in various sections of the report are a good indicator that the post communist governments have so far neglected financial sector reform and failed to take effective measures.

The Commission Report (1998) requires a lot of reading between the lines. In its overall assessment (termed "composite paper") the Commission is considering the formal criteria, but also the earlier assessment in the so called "Opinion", as published in the Agenda 2000 (Commission 1997). It is concerned to keep the incentive effect of the membership perspective alive. Thus, it is generally positive where it has been positive before, adding many "but"s and "providing"s and "if"s. The Commission remains reluctant with the second round countries, emphasising the necessity of a "track record", not making any concessions or upgrading today, but maybe in the future. In the detailed analysis, when putting the scattered pieces together one gets the feeling that the Commission is well aware of the disappointing development of the financial sector in the CE-10 which is mostly far from being satisfactory. The composite paper does not necessarily correspond to the individual country reports, the newly added dynamic element to the analysis is used somewhat uneven, and there are large differences regarding length and depth of the individual benchmarking.[5]

**Hungary**

Average market lending and deposit rates have continued to decline gradually in nominal terms and the spread between the two has fallen. In the past, weaknesses in banks' balance sheets and competition from new non-bank financial operators led to a fall in the stock of domestic credit extended by banks both in real terms and relative to GDP. While net credit to the government and to households and small and medium sized enterprises (SMEs) continued to fall sharply, credit to enterprises rose at an accelerating pace for the second year in a row. More than 90 per cent of total loans in 1997 were qualified as problem-free. Financial intermediation outside the traditional banking channels is expanding fast but non-bank corporate borrowing instruments still play only a marginal role. The process of privatization, covering most major banks besides troubled Postabanka and the largest commercial bank (OTP), so far resulted in a share of foreign ownership of about 60 per cent in total registered bank capital. With regard to OTP, the Hungarian State plans to turn its participation into a single golden share. This entails a rather large range of powers that need to be exercised properly. Postabanka, Hungary`s second largest retail bank, encountered a run on its deposits in Spring 1997.

[5] Dvorsky, Backé & Radzyner (1998): Candidate, p. 40f.

Initially, the authorities bailed out the bank, various re-capitalisations led to majority re-nationalisation, management was removed. Restructuring of the bank is still an open issue, no strategic (foreign) investor could yetbe foundt. As regulations were not enforced in a prompt and impartial fashion, the Postabanka affair has revealed worrying failings, suggesting there is still considerable scope for improving both regulatory laws and implementation. The Hungarian Banking and Capital Market Supervisory Authority enjoys a certain level of independence, but still is supervised by the Finance Minister. The partial independence of the supervisory institution has not always been synonymous of effective capacity to enforce the regulatory framework in a timely and impartial manner.

Since the beginning of 1998 and subject to a licence from the State Financial and Capital Markets Commission, branches of foreign credit institutions are allowed to operate in the Hungarian banking sector. Similarly, foreign investment firms and foreign insurers were recently allowed to establish branches on a national treatment basis. A new, three-pillar pension system was introduced that is supposed to increase the role of private agents in the pension system and to lead to a sharp increase in the share of national savings intermediated by the local financial sector from the currently low level. Most restrictions of medium and long term capital market transactions were lifted, while restrictions on short-term capital market and money market transactions remained intact. Most residents are not allowed to hold deposit accounts abroad. The continuing existence of anonymous banking accounts remains another concern for the Commission. Still, there is a need to consolidate the institutional and legal framework of financial markets in Hungary, the Hungarian Banking and Capital Market Supervisory Authority needs to be strengthened.

Given the large share of the emerging market-funds allocated by international investors into Hungary, the Budapest Stock Exchange, the (BSE) has been particularly affected by investors´ flight from emerging market assets.

**Poland**

In 1997, a series of laws, notably a new Banking Act and an Act on the National Bank of Poland, have been adopted. The new Banking Act will allow branching from foreign banks as of beginning of 1999. Majority stakes in Bank Handlowy and in Powszechny Bank Kreditowy (PBK) were sold in 1997. A Polish government plan to sell most of the remaining state assets by the year 2000 includes the remaining state banks, that is the state savings bank Bank PKO BP (Polands largest bank) and the group of co-operative agricultural banks BGZ, as well as the insurance giant PZU, which controls two thirds of the life and non-life insurance markets in Poland and was scheduled for privatization in 1999.

According to the Commission (1998), the prospects for further consolidation in the financial sector increasingly attracts the interest of foreign strategic investors. Domestic and foreign banks and insurance companies are seeking to exploit the market opened up through pension reform which might also give an impetus to the development and opening up of the securities market. Currently, there are no publicly traded corporate bonds and only a few municipal bonds. The over-the-counter exchange established in 1996 has so far attracted only 13 listings.

Until the end of 1998 Polish citizens can convert their privatization certificates into shares in the 15 National Investment Funds (NIFs) which were listed on the Warsaw Stock Exchange in 1997. The remaining restrictions on short-term capital movements should be lifted before the year 2000.

While provisions on large exposures and on money laundering have been strengthened, the establishment of a State Agency of Financial Information to effectively tackle money laundering is still missing. Access of households and small enterprises to bank credit seems to be improving. Nevertheless, the financial mediation between private saving and the financing of SMEs and new firms remains inadequate and underdeveloped. The access of small, medium-sized and new firms to the financial makets need to be improved. Moreover, some markets are still distorted because particular enterprises are allowed to operate on a loss-making basis, with pending implications for their creditors. Further efforts are also still required to liberalize capital movements in line with the EUs acquis, especially in the real estate area. These changes should help to move Poland´s financial market towards more maturity in terms of product range, markets and institutional organisation and allow for a full implementation of the Community acquis in the field of capital movements.

**Czech Republic**

One of the key weaknesses of the Czech economy continues to be the financial sector. According to the Commission (1998), the Czech banking sector remains burdened by an important bad loans problem with classified loans amounting to 29 percent of the loan portfolio by mid-1998. Some of the largest banks, especially the state-owned banks are still budened by a high proportion of bad loans, which by themselves are a significant contingent liability for the state budget in the coming years. Moreover, in the past, tax rules have discouraged high levels of provisioning. Consequently, necessary provisions were not built up.

The delays involved in bankruptcy procedures have dissuaded creditors from pursuing bad debtors. This has allowed the continued existense of some loss-making enterprises and an accumulation of bad debt by the banking sector. The buildup of a large number of classified loans in the Czech Republic has been due in part to the passive attitude the banks have adopted towards bad debtors. The intimate relationship between the financial sector and the enterprise sector which has not fostered financial discipline has been the main obstacle to a more rapid increase in the competitiveness of the enterprise sector. Hitherto, conflicts of interest between banks´ roles as both lender and proprietor have encouraged the practice of soft lending, and have prevented banks from taking an assertive attitude towards debtors.

In addition, the capital market is still illiquid, does not encourage strong corporate governance, and is a negligible source of finance for commercial and industrial enterprises. In the past the light regulatory framework and the wide variety of trading channels and practices led to the perception of non-transparent deals and price manipulation in the Czech capital market. The continued presence of divergent prices for the same stock due to the fragmented organisation of the securities market remains an important problem. The new Securities Commission established in 1998 is still dependent on the State budget for financing and does not have full regulatory authority, as regulations must be passed through the Ministry of

Finance to the government. It does, however, have important enforcement powers according to the Banking Act. As of June 1998, amendments made to the Investment Funds Act are designed to force the elimination of the weaker funds, to reduce the perception of fraudulent behaviour on the part of investment managers, to force investment funds to reduce their holdings in companies, to take measures for the protection of minority shareholders, and to encourage more active corporate governance by the financial sector.

Thus, the financial sector and the banking sector in particular is still in need of further restructuring. While the Czech republic had already achieved a very substantial degree of capital movement liberalisation, the same gaps in Czech financial services legislation that were identified in the Commission (1997) Agenda 2000 Opinion (missing alignment in the insurance sector, anonymous savings accounts in contradiction with the provisions of the EC money-laundering directive, consolidated supervision, capital adequacy) remain. Reforms proposed by the then government in 1997 include privatisation of the state-owned banks, measures to make the capital market more transparent, and measures to clarify the intimate links between the financial and enterprise sectors and to improve corporate governance. The scope of the Czech National Banks supervisory activities needs to be broadened to cover all aspects of the acquis. Insurance supervision and independence and autority of the Securities Commission need to improve. The privatisation of banks in the Commission (1997) opinion is key to improving the health of the banking sector, increasing the banks´ efficiency as well as to clarifying the links between the financial sector and the enterprise sector. A sale to strategic investors might lead to cleaning up of loan portfolios and a less passive attitude towards bad debtors than currently is the case.

As of February 1998, Amendments to the Banking Act prohibit banks from holding controlling stakes in non-financial firms, and set limits on their exposure to these enterprises. Banks are required to separate their commercial and investment banking arms to prevent banks´ equity positions from dictating lending policy as is currently the case. The Czech National bank has recently introduced more stringend bad loan classification and provisioning rules. As of September 1998, a second Amendment to the Banking Act tightens the terms for granting a banking license, broadens obligations on public information, provides for the same treatment of domestic and foreign investors in acquiring shares in banks and improves the deposit insurance system. Nonetheless, the links between the banking and enterprise sectors remain strong, and continue to prevent a clean up of bank portfolios and acceleration of enterprise resctructuring. Despite the improvements in securities markets supervision and regulation, Czech capital markets do not provide sufficient capital for companies. This is due in part to the non-existence of initial public offerings, the illiquid secondary market and weaknesses in the judiciary.

**Estonia**

Since the 1992 Estonian banking crisis the financial sector has been an area of particular attention for the authorities. During 1997 and 1998 Estonia has been confronted with the challenge of managing large capital inflows and addressing some of their unintended macroeconomic consequences, particularly with regard to rapid credit expansion (banks´ total loan portfolio more than doubled between September 1996 and September 1997) and growing external imbalances. The rapid decline in the Tallin stock market in the second half of 1997 and in the first half of 1998 revealed corporate malpractice, speculative operations on the stock market, and faulty control mechanisms in a number of financiel enterprises. Excessive optimism, easy access to funds and sharp competition for market share in the financial sector, in a context of rapidly expanding economy, were among the key factors that led to the emergence of these problems. The Russian crisis exacerbated problems already existing in two small banks, which were closed in September 1997 and also caused difficulties for the merger of Forex Bank and Investment Bank (which led the Central bank to acquire a temporary majority in them to ensure the completion of the merger). By closing down three banks between mid-1997 and October 1998, the authorities have reaffirmed their commitment to market principles. While the supervision authorities could probably have acted earlier to close down the Land Bank, when clear cases of fraud have been discoverd, legal proceedings have been initiated.

The Central Bank took measures to reduce credit expansion and strengthen the financial system, through a tightening of prudential regulations, the introduction of a deposit guarantee fund, by proposing consolidated supervision of financial conglomerates, through an increase of capital adequacy ratios from 8% to 10% and by the creation of a stabilisation reserve fund. In the context of the introduction of a uniform loan classification system, a general 2% reserve fund on all loans was created. These measures added to a liquidity crisis on the local money market and induced a substantial increase in interest rates and a decline in lending activity in the last quarter of 1997 and the early months of 1998, but helped to slow down the growth of banks´ total loan portfolio to an annual rate of 33% at the end of August 1998. The wide fluctuations in interest rates and the volatility on the domestic and international (i.e. Russian) financial markets have affected the financial sector, but its development has not gone off course, according to the Commission (1998). Even the voluntary or forced closure of some of the banks does not seem to have dented the general confidence in the financial sector. Deposits by residents briefly fell at the end of 1997, but then continued to grow. Foreign investors have continued to increase their stakes in the banking system, most notably in the largest Estonian banks. Also, the consolidation of the financial sector has led to the emergence of banks that are not only larger but also stronger, and thus in a better position to channel savings to productive investments.

In the insurance sector, the legal framework was aligned with EU provisions on annual accounts and consolidated accounts of insurance undertakings in 1998. In addition, a single supervision authority for the banking, securities and insurance markets was proposed. The government has launched the reform of the pension system which is based on the usual three pilllars (a state-managed scheme, a company managed pension fund scheme and a private voluntary scheme). The former state insurance monopoly continues to have its market share reduced. There is still a substantial market share in life insurance but a rather modest share in non-life insurance (less than 20%).

Although Estonia has taken some steps to reform public administration and the judiciary, and while there has been further progress in strengthening the structures of a market economy, notably by significantly tightening banking supervision, progress is slow and administrative shortcomings exist in key areas such as financial market supervision and state aid monitoring.

The rapid development of the non-bank financial institutions has not been matched by a strengthening of the relevant supervisory agencies. While work has started on establishing a consolidated financial supervisory authority, it is important to make further progress on strengthening existing supervisory agencies and extending the regulatory framework to all parts of the capital market. There also is an urgent need for the Estonian Parliament to adopt legislation on the prevention of money laundering (Comission 1998). The current reorganisation of financial control institutions needs to be sustained and consolidated in order for Estonia to be in a position to effectively use EU funds.

The reliance on foreign capital to finance a large part of the current account deficit continues to create risks for macroeconomic stability. A continuation of the strong private sector foreign debt growth would severely undermine the sustainability of economic policy, including the exchange rate regime. The high level of short term foreign capital exposes Estonia to the risk of a shift in private investors′ confidence, which might ultimately lead to turbulence.

**Slovenia**

Although the financial sector is sufficiently developed to allow the functioning of the economy, it is still far from being internationally competitive in terms of product variety, soundness and costs. Costs are high and the financial sector remains small in absolute and relative terms. Restrictive measures imposed by the Bank of Slovenia, for example in the field of portfolio investments (obligatory custody accounts) and external credits and loans (obligatory interest-free tolar deposits) have been partially eased in 1998, but still are in place. Some consolidation of the banking sector is progressing with the formation of a fourth banking group by Banka Koper and M Bank, and with Banka Domnale joining the state-owned Nova Ljubljanska Banka (NLB) group. The insurance sector is poorly capitalised and its restructuring is still in the early stages. The reform of the pension system is a particular challenge for Slovene public finances. Capital markets reamain shallow and underdeveloped. There are still gaps relative to the acquis on securities markets. The principle of national treatment for foreigners wishing to establish or acquire an investment firm in Slovenia has still to be introduced.

Because of the remaining problems of the banking sector, and the underdeveloped financial sector in general, enterprises have difficulties to finance the investments needed for their restructuring. Due to high operating costs in the banking sector, real credit interest rates are high. The links between bigger enterprises and their banks are often strong, so that the latter do not exert sufficient financial discipline on the former. Supervision in the financial sector is not yet sufficiently strong, and a cartel still operates in the banking sector. Because of continued high state involvement, the financial sector lacks competitive pressure. The main factor that is preventing rapid consolidation of the banking sector is the pending privatisation of state-owned banks. Slovenia has not yet taken appropriate measures to allow foreign banks to open branches as previosly recommended by the Commission (Agenda 2000). Liberalisation of capital movements is still very slow.

Authorities have announced by not yet implemented measures to strengthen capital markets to consolidate enterprise ownership and to improve corporate governance. Bank privatization will be a trigger towards consolidation of the banking sector, on condition that banks are sold to strategic, possibly foreign investors, in a transparent and non-discriminatory way. Major efforts are still needed to improve the development and competitiveness of the insurance sector and of money and capital markets.

**Slovakia**

The functioning of the Slovak market economy still needs to be improved. Slovakia has implemented most of the reforms necessary to establish a functioning market economy, but there has been a lack of transparency due to government interference. In February 1998, rules for the admission of securities to the Slovak capital markets, for investment by residents in foreign securities and for foreign currency operations were relaxed, foreign currrency surrender requirements for residents were partly abolished. Measures to combat money laundering, increased capital requirements and accountancy and supervisory measures were adopted. However, the pace of structural reforms continues to be slow and the situation in the banking sector deteriorated. Continued lack of transparency in the privatisation process and the lack of foreign direct investment have negatively affected enterprise restructuring. Privatisation has continued through direct sales, often at preferential terms with the possibility of spreading the payments to the National Property Fund (NPF) over a period of up to ten years. However, an important number of privatisations have lacked transparency and fairness.

Additional examples of unannounced sales of shares of listed enterprises at sharply reduced prices, often to unknown buyers, have been recorded. A group of "essential" enterprises, including the financial sector, has been excluded from privatisation. Debts to bondholdes or

banks can be rescheduled or cancelled under the Enterprise Revitalisation Act through a secretive and untransparent procedure with important political involvement. The unequal treatment of minority shareholders in listed companies in the privatisation process reduced the attractiveness of the stock exchange, particularly for foreign in investors, no independent securities commission has been created yet. Capital markets therefore remain fragmented and illiquid, and progress is still needed in their regulation.

The Slovak financial sector still has considerable restructuring problems to resolve, its problems are damaging overall economic efficiency. Interest rates on domestic Slovak financial markets are very high because their liquidity is squeezed by the ongoing restrictive monetary policy, which is necessary to counter excess domestic demand. The government's high financing needs crowd out credit to the private sector. The high and volatile real interest rates created additional problems for the weaker banks, particularly for those institutions that depend on the interbank market for their financing.

The financial sector is dominated by a number of state-owned banks and banks in general have a high proportion of non-performing loans, the Supervisory Department in the Slovak National Bank needs to be strengthened in this respect. After a significant reduction in 1996, the proportion of bad loans in the three biggest banks which are fully or partly state-owned increased in 1997 to a 39% of total loans. At the end of the first quarter of 1998, five banks did not fulfill the capital adequacy requirements. Investicná a Rozvojová Banka (IRB), the third larges bank, encountered serious liquidity problems, and had to be put under forced administration by the National Bank of Slovakia in December 1997. Because the main private shareholder, the VSZ Steel group with at the times strong ties to the Meciar government, refused to increase the capital the bank was recapitalised in June 1998 by Slovenska Poistovna, the state owned Slovak Insurance Company with about 80 percent market share which became the major shareholder.

Selling to domestic industrial groups, however does not fundamentally improve the financial sectors capacity to restructure. Most new owners of privatised enterprises typically lack the financial means that are needed for restructuring, since they already had to invest to acquire the control of the company. Resultingly, investment for restructruring has to be financed exclusively from retained earnings of the enterprises, which is only possible for firms that are already profitable.

Because of the precarious situation of the government budget, the state will also not be able to cure the solvency problems of the state-owned banks. Therefore, there is a need to prepare a rapid sale of the banks to strategic, most probably foreign, investors. In February 1998, an amendment to the banking act entered into force which aims at removing the two-level licensing procedure and the discrimination of non-residents in the area of acquisition of bank equity capital. So far, however, Slovakia has not been able to attract significant amounts of foreign direct investment, while the financing capacity of the domestic financial sector remains limited by the bad-debt problem and high interest rates.

The worsening of Slovakia's credit rating reduced its acces to international financial markets and led to significantly higher coupon rates of governmental eurobond issues. The structure of foreign debt is increasingly short-term, which could cause problems if the observed reluctance of international financial markets to finance economies with weak banking sectors after the Russian crisis continues.

Provided that the macroeconomic difficulties and the remaining structural problems are tackled swiftly and in a transparent and market-based way, Slovakia should be able to cope with competitive pressure and market forces within the Union in the medium term, according to the Commission (1998).

**Latvia**

The banking sector continues to strengthen and is increasingly fulfilling its role as a financial intermediary. In 1997 and early 1998, developments in the banking sector continued to be favorable. The profitability of the financial sector and its capital base increased and the quality of loan portfolios improved. By mid-1998, there were 30 banks in operation, of which 25 were permitted to accept household deposits. Three bank licences have been removed since January 1997. Declining interest rates led to lower interest payments by the government and smaller fiscal deficits. The withdrawal of the government as a major borrower from commercial banks has encouraged a reduction in interest rates and led to a sharp growth in the volume of new bank lending. Aggregate bank credits grew by 74% in 1997, and a further 19% in the first quarter of 1998. The rapid expansion of the financial sector extends to non-bank financial institutions, especially insurance and leasing companies. Nevertheless, the overall level of financial mediation in the economy remains low; credit represented only 11.7% of GDP at the end of 1997, and the loan/deposit ratio was only 46%. The establishment of a mortgage register, which will enable enterprises to secure mortgages without taking the mortgaging items out of business activity is in the making.

Non-performing loans have declined recently, even in absolute terms, and by the end of the first quarter of 1998 they were only 8% of the loan portfolio. While at present the quality of the loan portfolio is improving, it will be important to ensure that the pace of credit growth does not lead to a deterioration in the quality of the loan portfolio. The overall Russian exposure of the Latvian banking sector is estimated at 8% of total banking assets, with 3.5% of assets held in GKO's. The 1998 Russian crisis led to difficulties in some Latvian banks. A small bank was closed, one large bank faced a run on deposits initially, but the situation of this bank has since stabilised. Although the exposure is high, it does not pose a systemic threat to the stability of the Latvian banking system (Commission 1998). However, the Commission (1998) also states that it is premature to assess the full impact of the deterioration of the situation in Russia on the Latvian economy.

The expansion in lending by the domestic banking sector and rising foreign exchange transactions by the Bank of Latvia triggered a rapid growth in money supply. One point of concern on the macroeconomic side is the growing size of the current account deficit (-6.3% in 1997). Although large, it is covered by high inflows of of foreign direct investment (FDI). However, a significant proportion of the FDI accumulated has been in recent years, and these inflows need time to have a significant impact on the reorientation of the economy. Due to the impact of the deterioration of the situation in Russia and its influence on the international investment climate, the inflow of investment could be adversely affected. The Commission (1998) therefore recommends policies aimed at reducing external imbalances by encouraging increased domestic saving.

The rising FDI inflow can be attributed to the acceleration of the privatisation process. By October 1998, 1039 of the 1097 enterprises allocated for privatisation since 1994 had been transferred to majority private ownership. The completion of sales of some of the roughly 60 remaining state enterprises could be difficult and could involve further delay. In some of these cases there has been some reluctance to use privatisation methods which would ensure the establishment of competition in the sector concerned. Substantial stakes of the enterprises already considered to be privatised were allocated for privatisation by voucher. Moreover, there are many minority stakes which remain to be privatised. So far, the uptake of shares in enterprises by voucher holders has been limited. Even with a higher rate of uptake of shares by voucher holders, voucher privatisation still carries the risk that enterprises will have a diffused and passive share ownership structure, which could mean that enterprise restructuring progresses slowly. Secondary markets enabling the trade of share holdings and allowing a concentration of ownership are important for mitigating any negative impact of voucher privatisation. The Riga Stock Exchange has developed quickly, from a capitalisation of 2.7% of GDP at the end of 1996 to 6.3% of GDP at the end of 1997. Turnover is also increasing. There are, however, major concerns about the impact of the economic crisis in Russia on the Latvian capital market and the Latvian financial sector in general.

The Latvian authorities have made considerable progress in establishing the institutions of a market economy. Concerning free movement of services, there has been a notable strengthening of the banking sector which owes much to the strict supervision of the Bank of Latvia. Banking supervision and prudential regulations are generally of a high quality, stricter disclosure and capital adequacy requirements and a deposit guarantee scheme were recently introduced. However, supervision of the non-bank financial sector (insurance, leasing) is still weak and the governments′ plans to establish a single regulatory authority for the whole financial sector may take some time to be implemented. Latvia has continued to make steady progress in its programme of economic reforms and in the creation of a functioning market economy. However, many important reforms are in progress, or have only recently started to be implemented, which makes it difficult to give an overall assessment of the effectiveness of the reforms and of the institutions that have been created. Continued maintenance of macroeconomic stability and sustained progress with the reform programme would enable Latvia to make the progress necessary to cope with competitive pressures and market forces within the Union in the medium term. The authorities should give priority to filling the reamaining gaps in the regulatory and supervisory framework, especially in the financial sector. Priority should also be given to maintaining macroeconomic stability, in particular through policies aimed at reducing external imbalances by encouraging increased domestic saving.

**Lithuania**

The legal framework for a market economy has improved. However, Lithuanian laws are frequently amended while the establishment of proper implementation structures often lags behind due to a lack of administrative capacity and of clearly defined medium-term strategies. Advances in bank restructuring and strategic privatisation have often been driven by ad hoc decisions. The financial sector is strengthening and expanding its role as financial intermediary. All insurance companies completed reorganisation of their activities and amendments to their regulations. Since 1997, the banking sector is increasingly fulfilling its role as a financial intermediary. As a result of privatisation and rising foreign direct investment, the availability of physical, managerial and technological capital for enterprise restructuring is increasing. Nevertheless, the overall level of development of the financial system remains low. At the end of 1997, broad money represented only 19% of GDP, credit only 11%. It will be important to ensure that on-going credit growth does not lead to a deterioration in the quality of the loan portfolio or to dangerous mismatches in the currency denomination (or terms of maturity) of bank assets and liabilities.

After the banking crisis of 1996, confidence was gradually restored onwards, banking activity increased rapidly. Broad money and total credits have been growing at double-digit rates in real terms after negative growth in 1995 and 1996. The real value of loans extended by the financial sector has also been growing rapidly since mid-1997, mainly thanks to the growth in foreign currency lending. Nominal interest rates on deposits and loans, average rates on Treasury bills and premia on financial instruments denominated in Litas all tended to fall until late into 1997.

As of July 1998, 10 commercial banks were operating along with two branches of foreign institutions and five representative offices. At the beginning of 1998, foreign investors owned one third of the share capital of Lithuanian banks and had controlling stakes in the two largest private institutions. Since 1994, thirteen banks saw their licences removed and entered bankruptcy proceedings. For eight of them liquidation has begun. A law enacted in April 1997 granted a one-year exemption from prudential requirements for the two state-owned banks for privatisation. A year later, the authorities decided to liquidate the State Commercial Bank, after repeatedly failing to find a buyer. In September 1998, the privatisation tender for the other, Agricultural Bank, failed; a new tender is pending. Dietuvos Draudimas, the largest Luthuanian insurance company with a market share of 55% and the state-owned Savings Bank still need to be privatised. At the end of August 1998, public-owned banks still accounted for some 40% of all outstanding loans from functioning commercial banks. However, this share has been falling sharply and direct funding of the agricultural sector by public banks has stopped. In addition, a fairly active leasing market has facilitated a measure of agricultural restructuring.

The Lithuanian National Stock Exchange has developed quickly. Its capitalisation reached 27% of GDP at the end of 1997 and turnover has increased substantially. Enterprise financing through the issues of equity and debt securities is growing. The persistant lack of interest from investors for some enterprises could change when corporate govenance is strengthened and the bankruptcy law is applied more aggressively. Part of the proceeds of future privatisation is being channeled to a savings institution restitution fund which will be used to compensate households for the financial losses incurred at the beginning of the reforms.

The legislative framework governing the financial sector has developed rapidly, a new banking law was adopted in 1997. Advances were most noticeable in supervision of the banking sector and prudential requirements. Capital adequacy requirements, exposure rules, reporting obligations, the prohibition of insider trading and deposit insurance were strenthened. Supervision of the non-bank financial sector is still weak but the authorities are making efforts to strengthen it.

The consolidation of macroeconomic stability and the advances of Lithuania's transition to a fully functioning market economy are progressively improving its prospects of being able to cope with competitive presssures within the single market. The main risk on the macroeconomic side is that it may become difficult to finance the high and rising current account deficit. Preserving the macroeconomic stability and completing the reform agenda, in particular the planned privatisation of banks and financial enterprises would strengthen favourable trends, enabling Lithuania to make the progress necessary to cope with competitive pressure and market forces within the Union in the medium term.

While a deterioration of exporters' financial performance due to the Russian economic crisis in 1998 could negatively affect the loan portfolio of commercial banks, their reserve position should be more than sufficient to make provisions against such a deterioration. Concerning free movement of services the situation remains somewhat unsatisfactory as it is not clear that the Lithuanian authorities have the administrative resources to implement quickly the large legislative program to which they have committed themselves.

**Bulgaria**

Following the economic and banking crisis of 1996/1997, a series of measures were adopted to restructure the Bulgarian financial sector and strengthen regulation of the banking and financial services market. The deep recession which Bulgaria suffered in 1996 and 1997 brought normal banking activity almost to a halt. Since mid-1997, Bulgaria's general economic performance has significantly improved. The core of Bulgaria's successful stabilisation has been the operation of a fixed exchange rate under a DM-based currency board regime. The size of the domestic money supply is now dependent on the central bank`s stock of foreign exchange, according to the rules of the currency board arrangement. The central bank cannot lend directly to the government. The rules of the currency board also foster financial discipline as banks and companies have to repay loans with no prospect of being bailed out by the state.

Major reform of banking legislation accompanies the establishment of the currency board. Regulation of the banking sector has been strengthened by the adoption of a new Banking Act and complementary adjustments to all major regulations on banking supervision (own funds, solvency ratios, bad debts, etc.) and by legislation on deposit guarantees and money laundering. Nevertheless, the current payment system in Bulgaria cannot be considered sufficiently advanced, and some time is needed to appreciate how the new legislative banking framework will be applied in practice. The State Savings Bank, which still holds most household savings, is being transformed into a commercial bank. A self-funding deposit insurance scheme has started operating. The financial position of the banking sector has improved significantly. Bankruptcy and liquidation procedures remain slow, however, notably in relation to the 15 banks which were closed in 1996. All remaining banks meet the minimum capital adequacy ratio of 8% and this ratio is gradually being raised to 12% by the end of 1999. There has been a sizable inflow of foreign currency to the banking system. This has come from foreign direct and portfolio investment and from the fact that Bulgarians have converted their savings from foreign currencies back into Leva. While the exposure of Bulgarian banks to Russia is limited, exports to Russia accounted for 8% of total 1997 exports, those to other CIS countries for 18%. However, the Russian crisis could create financing difficulties for Bulgaria, as its access to international financial markets may become more difficult and as the increased aversion of international investors to emerging markets may cause capital inflows to diminish.

Bank privatisation was started with the sale of one bank in 1997 and the completion of a second bank privatisation in 1998; three more were scheduled for 1998 initially. Sustained pressure from international institutions has been necessary to keep bank privatisation moving forward, however. The government has sometimes appeared uncertain about the necessity of far-reaching reforms and the national authorities have intermittently made statements which sent mixed signals about the government's commitment to rapid bank privatisation. Successful completion of the privatisation of the banking sector should help to boost banks' lending skills.

The Bulgarian government also attempted to accelerate enterprise privatisation and to increase the processes' transparency by contracting out the privatisation of several large companies. The cumulative share of divested long-term assets of enterprises amounted to 20% at the end of 1997. However, many firms have been bought by their existing management and employees. Although this is helping to consolidate support for market reforms, it may slow down the rate of improvements in competitiveness since it may not be conducive to rapid restructuring. Moveover, questions may be raised about the ability of worker-owned firms to undertake restructuring when it requires laying off workers. The new owners are unlikely to have substantial funds of their own with which to undertake investment in modern plant and equipment. They may face special problems in raising finance because the banks have little experience of lending to such enterprises, and also because banks are currently adopting a very cautious approach to lending.

The authorities have announced their intention to privatise companies by offering shares through the stock market. So far, little has happened in this area. The Bulgarian Stock Exchange became operational in late 1997, but trade is still limited. To date, shares are listed in just one company on the official market, but an active over-the-counter market has appeared. The authorities are also keen to sell some companies by distributing privatisation vouchers to the population. The number of investment intermediaries increased as a result of the transformation of the former Privatisation Funds into investment funds. The Securities and Stock Exchange Commission also licensed a number of banks and investment funds to serve as investment intermediaries. Experience in other countries has shown that this sort of privatisation can produce a diffuse ownership structure which is unable to exercise effective control over the enterprises.

As the recovery strengthens and economic activity picks up, the ability of banks to act as responsible providers of investment finance will come under increasing attention. The current ability of the Bulgarian financial sector to fulfill the role of financial intermediation between savers and investors in the changed circumstances of the currency board arrangement remains largely untested. Banks have to date undertaken very little new lending, so it is impossible to assess whether they are able to act as responsible financial intermediaries. The government's ability to borrow money at low rates suggests that banks are either reluctant or unable to lend for productive investment because of the need to strengthen balance sheets. This is likely to constrain economic growth.

In the Bulgarian insurance sector, there is a danger of monopolisation of the market by the former state insurance companies since the requirements for licensing are very high. Progress has been made in bringing insurance legislation into line with the acquis although the insurance market is still underdeveloped.

The reforms which are presently being executed are helping to improve Bulgaria's international competitiveness. They are still at a relatively early stage, however. Although the health of the financial sector has improved through a combination of measures such as recapitalisation, closure of weak banks and strengthening of supervision, banks are not fully playing their role of financial intermediaries. Substantial enterprise restructuring is still required and further reforms are still needed to improve the efficiency of the banking system and to establish a competitive financial sector.

**Romania**

More than half of the commercial banks' assets were non-performing at the end of 1997 and overdue loans increased from 23% in December 1997 to 31% in mid-1998. The worsening of the situation led the authorities to carry out the massive recapitalisation in 1997 through the issue of government bonds amounting to 1.4% of GDP. The interest payments linked to these bonds have increased expenditures in 1998 by as much as 1.7% of GDP. Since mid-1997, there is a growing reluctance of international finance to commit resources to Romania, whether in the form of direct investments, portfolio investments or bank lending. Repeated failure to deliver on its national and international commitments has been detrimental to Romania's standing within the international lending community and led to a repeated downgrading.

The increasing weakness of banks has been reflected by a sharp decline in foreign assets during the first half of 1998. The amount of credit to the nonbank sector shrank from 24.5% of GDP at the end of 1996 to 14.4% of GDP at the end of 1997. The share of credits denominated in foreign currencies has increased, thereby raising the risks linked to a devaluation of the currency. Banks have increasingly invested in treasury bills, which carry high returns. The market for working capital and long-term capital is not functioning satisfactorily, as local banks have reduced their exposure to the non-government sector and are extending credits only with very short-term maturities.

More fundamentally, the absence of a properly functioning market economy, and the non-respect by a large number of economic agents of their contractual obligations do not ensure a sound basis for economic activity. Corporate governance in banks has not improved. Given the uncertain prospects for privatising the largest of the public banks, there is still a strong possibility of moral hazard. This calls for a major strengthening of supervision activities and for addressing the absence of financial discipline in public companies and entities which has been the fundamental problem of the Romanian economy. Respect of contractual obligations, including timely payment of creditors remains elusive in Romania. Data on arrears to banks show a major increase from 1% to 5.6% of GDP between June and December 1997. The government is accumulating large tax arrears and unviable companies have not been liquidated. The special credits that the National Bank of Romania (NBR) had been forced to extend to agriculture and enterprises were terminated and the new statute of the NBR limits the amount of financing that it can temporarily grant to the government, which are important achievements in the improvement of the framework for monetary policy (Commission, 1998).

Following the liberalisation measures implemented in 1997, the foreign exchange market has continued to function well. This has allowed the authorities to announce the full convertibility of the Leu for current account transactions in March 1998. In the field of the liberalisation of capital movements, restrictions on outflow of FDI, profits and dividends have been removed and the T-bill market was liberalised for non-residents in 1998. No significant progress has been reported on the alignment of Romanian legislation to the acquis on securities markets. Serious gaps persist in relation to insider regulations, general information to be provided to the public and as regards authorisation and capital adequacy requirements for investment firms. Repeated changes in the legal framework for foreign investment and privatisation have made foreign investors cautious to invest in Romania since the autumn of 1997. While activity and capitalisation of both the official Bucharest Stock Exchange (BSE) and the over the counter RASDAQ markets have fallen sharply since then, both are quite modern (Commission, 1998). The RASDAQ representes mainly minority shareholding in state controlled companies and still performs poorly, however. Reporting on companies contributes little to the transparency of markets. Both stock exchanges have not been used sufficiently in the context of privatisation nor as vehicles for raising long term finance. While the National Securities Commission (CNVM) is formally politically independent, its members face political influence and pressure from the major market actors.

As regards insurance, the Office for Supervision of Insurance and Reinsurance Activities (OSAAR) ist not independent yet and is included in the structure of the ministry of finance. OSAAR is a weak institution with almost no political support and insufficient budgetary endowment to become a strong supervisor of the market. The privatisation of the two state owned insurance companies which dominate the Romanian insurance market was initiated in early 1998.

The recent enactment of three important laws in the financial sector (the law on Bank Bankruptcy, the Banking Law and the new statutes for the NBR, a law on money laundering) has greatly improved the legislative framework. This new legislation is designed to consolidate the central bank's independence, its supervisory capacity and the prudential regulation of the banking system. The NBR now is the sole licensing and supervisory authority for commercial banks. While the National Bank was granted increased powers by the new 1998 Banking Law, it has failed to react appropriately in dealing with several troubled banks so far. It remains to be seen how the new laws will be implemented. Moreover, only a radical and sustained improvement in the overall macroeconomic conditions as well as the imposition of financial discipline throughout the economy will lead to a meaningful improvement in the situation of the financial sector, and thus to the emergence of banks able to foster the sustainable development of the private sector.

## 4. Conclusion

In the analysis of the financial services matters mentioned in various parts of the Commission (1998) country by country progress reports, several issues stick out. There is at times an interesting diversity of views between a country's detailed analysis following the various Copenhagen criteria (functioning market economy etc.) and the country-specific conclusions and recommendations by the Commission (1998). For example, in the detailed analysis of the Czech Economy the Commission refers to the financial sector as one of the key weaknesses in need of restructuring and that the sector is unable to provide corporate governance due to the burden of an important bad loans problem, due to the fact that the financial sector is too much intertwined with the enterprise sector and because the capital market is illiquid.

In the more general assesstment the Commission avoids explicit deviation from its earlier judgements. By contrast to the detailed analysis the Commission (1998) concludes that the Czech Republic will meet the economic and acquis criteria at the time of accession, provided that corporate governance is improved, enterprise restructuring is accelerated and that administrative structures are rapidly strengthened. It does not explicitly phrase the decisive matter, i.e. there is no explicit sentence saying that presently the financial sector is not meeting the criteria, that the financial sector is not sufficiently well developed to channel savings towards productive investment etc.

The general statements read as: The Czech Republic and Slovenia have lost some ground. Estonia and Latvia, to a lesser extent also Lithuania and Bulgaria made progress, the situation in Romania deteriorated. Given the recent change in the Slovak government, the Commission (1998) argues that it is premature to assess.

While the Commission shows a committment towards advocating EU enlargement as outlined in the (1997) Agenda 2000 framework (i.e. a separation in round one and round two countries), a true and fair sectoral view can only be derived from a cross-sectional analysis of the detailed material collected by the Commission (1998).

By analysing the Commissions (1998) country-by-country statements on financial sector issues, the following generalisations can be derived:

*** Low and fragile level of financial intermediation hampers the accession countries economic growth:**

Stock exchanges remain small, illiquid, underdeveloped and of a questionable reputation.

Bank assets grow rapidly, the overall level of financial mediation in the accession countries economies remains low, accompanied by high interest rate levels and a high fraction of questionable debt in most cases. While the current level of financial intermediation is discussed for some accession countries, no specific reference is made to possible future scenarios.

*** Corporate governance of and by the financial sector does not yet work in the CE-10:**

Lack of implementation of financial sector regulations: Some countries lack the political support for adjustment to the EU's market based setup. Most countries made considerable progress in establishing the institutions of a market economy. However, a variety of reasons hamper the actual implementation in market-based financial markets:

Privatisation, esp. of banks and insurance companies is still pending, but also non-privatisation of "strategic" sectors. Where enacted, especially by using vouchers, privatization often led to intimate and privileged bank-company relationships. Banks, therefore, frequently cannot provide regular corporate governance as is the case in true market economies.

Weak supervision of financial institutions: slow (no) pace of reforms, limited digestion and adjustment capacities of supervisory bodies and the courts, dependency of supervisory institutions on government finance and/or other support. Supervision of the non-bank financial sector (insurance, leasing) is still weak and most CE-10 governments plan to establish a single regulatory authority .

The states hand is still too visible: In most CE-10 countries the stock of existing state debt is still crowding out new private bank credit. The ability of governments to borrow at low rates suggests that the respective banks are either reluctant or unable to lend for productive investment, because of the need to strengthen balance sheets. Continued state interference is is likely to constrain economic growth in the respective countries.

On the one hand, there is a strong dependence on FDI inflows as external deficits are large and growing. On the other hand, negative attitudes towards foreign bank and company ownership, the major source of FDI, prevail.

While the Commission (1998) does refer to the necessity of corporate governance reform in several countries, the EBRD (1998) is more explicit in finding that effective structures of corporate governance have yet to be established even inthe most advanced transition countries and in arguing that this impedes enterprise performance. Major improvements are still required in the financial sector to provide a disciplining source of finance for investment and a market in which changes in ownership and control can take place (EBRD, 1998). Corporate governance in the Central European accession countries is discussed in more detail in Fink/Haiss (1998) and in Fink/Haiss/Orlowski/Salvatore (1998b).

- **Type, maturity and magnitude of FDI matter:**

Vulnerable dependence on short-term FDI: Several CE-10 countries, especially the smaller ones, have high and growing current account deficits. Since foreign direct investment (long-term capital commitment) is discouraged, the financial gap has to be closed by short-term foreign investment. In case that inflows stop or funds are withdrawn, the Commission (1998) foresees "serious macroeconomic problems" (a debt crisis?) to arise.

Foreign involvement helps: The financial sector seems to be more advanced in countries like Hungary, Estonia and Latvia (to a lesser extent Poland) that allowed strong foreign equity (i.e. long-term) involvement in the banking sector. For most of the other accession countries, the Commission (1998) advocates increased foreign involvement in the banking sector to improve the efficiency of financial intermediation.

We conclude that the financial sector and/or its regulatory and supervisory framework remains a major reform priority for all CE-10 accession countries and therefore will become a stumbling stone for EU membership. Moreover, future assessments also shluld consider the consequences of sometimes ill advised economic policy making by governments of the candidate memers. The present deviation from equilibrium exchange rates and short term financial flows may even endanger the financial sector of the member candidates if it would be strong and healthy (which is not the case). Central banks of member candidate countries are still financing banks and/or governments. Financial policy of many of the member candidate countries is not in line with the stability pact of EU member states.

**Annex Table 1: Reform Priorities of Member Candidates**

| Country | Economic Criteria | | Acquis Criteria incl.EMU | Over-All Reform Priorities |
|---|---|---|---|---|
| | Existence of a functioning market economy, including that the financial sector is sufficiently developed to channel savings towards productive investment | Capacity to withstand competitive pressure and market forces in the medium term, including the availability of a sufficient amount of capital at an appropriate cost | Ability to take on the obligations of membership in the medium term, incl. aims of EMU (capital move- ments, nat'l bank status & financing, public sector / fin. institutions-relations). | |
| Hungary | Hungary remains a functioning market economy. There is, however, a need to consolidate the institutional and legal framework of a market economy, esp. with regard to monopolies and financial markets. | Hungary should be well able to cope with competitive pressures and market forces within the Union in the medium term, provided the conditions supporting trade integration and ongoing enterprise restructuring are preserved. | Hungary made progress in building up administrative capacity to apply the acquis, but financial sector supervisory bodies need to be strengthened. Few prob-lems for participation in EMU as non-participant in the euro area, if necessary measures are implemented. | implementation and enforcement of regulation in<br>- regulated enterprises<br>- **financial sector**<br>- health sector |
| Poland | Poland can be regarded as a functioning market economy. The financial sector is developing and increasingly attracts the interest of foreign strategic investors, but still has to mature. Bringing the grey part of the economy into the open is one of the main challenges. Some markets are still distorted. | Poland should be well able to cope with competitive pressure and market forces within the Union, provided it strenghtens the pace of economic restructuring and continues to avoid reversals in trade policy. However, the financial mediation between private saving and the financing of small & medium-sized enerprises remains inadequate. | Poland experienced difficulties in implementing planned reforms to apply the aquis. Further attention is required on supervisory capacity in the financial sector and in liberalising capital movements. Few problems for Polish participation in EMU as non-participant in the euro area, provided necessary measures are undertaken. | - privatisation<br>- coal, steel, agriculture<br>- public finances<br>- **financial sector** & pension reform<br>- **access of SMEs to financial markets**<br>- bringing grey economy into the open |

Source: Fink/Haiss (1999), derived from the financial sector in the EU Commission (1998) Progress Report.

**Table 1 continued**

| Country | Economic Criteria | | Acquis Criteria incl.EMU | Over-All Reform Priorities |
|---|---|---|---|---|
| Czechia | Although the Czech Republic can be considered to be a functioning market economy, there is still considerable scope for improvement and accelerated structural reform to improve its prospects for coping with competitive pressure in the Union in the medium term.. | The Czech Republic can continue to be regarded as able to cope with competitive pressure and market forces within the Union in the medium term, provided that it vigorously implements its programme of reforms, especially improves corporate governance and accelerates enterprise restructuring. One of the key weaknesses of the Czech economy continues to be the financial sector. | Czechia has not yet translated the political commitment into concrete actions. The scope of the Czech National Banks supervisory activities needs to be broadened to cover all aspects of the acquis. Insurance supervision and independence and authority of the Securities Commiss-ion need to improve.<br>Few problems for Czech participation in EMU as non-participant in the euro area, provided necessary measures are undertaken. | - **corporate governance (esp. links between banking and enterprise sectors)**<br>- **privatisation, esp. banks**<br>- enterprise restructuring<br>- **internal market**<br>- **financial sector (cleaning up banks' loan portfolios, increase capital market efficiency)**<br>- agriculture<br>- justice & home affairs |
| Estonia | Can be regarded as a functioning market economy, but financial markets have to mature. Through consolidation, the financial sector now is in a better position to channel savings to productive investments. | Estonia should be able to cope with competitive pressure and market forces within the Union in the medium term provided government takes urgent steps to limit risks from high external deficits, including dependence on large short-term capital inflows. | Estonia has taken some steps, but administrative shortcomings exist in key areas such as financial market supervision and state aid monitoring. Few problems for Estonian participation in EMU as non-participant in the euro area, provided necessary measures are undertaken. | - reduce external imbalance & dependence on foreign capital inflows<br>- price liberalization<br>- land privatization<br>- stimulate R&D & skills<br>- **strengthening of the regulatory framework of financial activities and capital markets** |

Source: Fink/Haiss (1999), derived from the financial sector in the EU Commission (1998) Progress Report.

**Table 1 continued**

| Country | Economic | Criteria | Acquis Criteria incl.EMU | Over-All Reform Priorities |
|---|---|---|---|---|
| Latvia | Latvia made strong progress on the creation of a fully functioning market economy. The banking sector is increasingly fulfilling its role as a financial intermediary. The remaining gaps in the regulatory and supervisory framework, esp. in the financial sector need too be filled. If reforms already underway are implemented, market economy criteria may be met. | Many important reforms are in progress or have only recently started to be implemented which makes it difficult to give an overall assessment. While Latvia is well on the way, continued progress with the reform programme would enable Latvia to make the progress necessary to cope with competitive pressures and market forces within the Union in the medium term. | Latvia has made a lot of progress in transposing the acquis, e.g. in bank supervision, but needs to consolidate its implemen-tation and enforcement capacity. Provided it does so Latvia will be able to apply the acquis effectively in the medium term. Participation in EMU as non-participant in the euro area might cause serious problems; few problems if ongoing reforms continue. | - **fill gaps in regulatory & supervisory framework, esp. in financial sector**<br>- simplify legal environment<br>- complete privatisation<br>- **raise domestic savings rate** to provide macro economic stability |
| Lithuania | Since 1997, the banking sector is increasingly fulfilling its role as a financial intermediary. There has been further progress towards the creation of a market economy. Sustained implementation of the remaining reform agenda would complete the establishment of a functioning market economy. | Preserving macroeconomic stability and completing the reform agenda, in particular the planned privatisation of banks and financial enterprises and the reform of the energy sector would strengthen favourable trends, enabling Lithuania to make the progress necessary to cope with competitive pressure and market forces within the Union in the medium term. | Lithuania has made progress in transposing the acquis, although this is uneven. Concerning free movement of services it is not clear that the authorities have the administrative resources for implementation and enforcement capacity. Participation in EMU as non-participant in the euro area might cause serious problems; few if ongoing reform continues. | - **complete implementation of reforms (e.g. financial sector and availability of capital)**<br>- bancruptcy proceedings<br>- maintain macroeconomic stability, eps. sustainability of external accounts<br>**-privatization, esp. banks & financial enterprises**<br>- long-term energy plan & reform of energy sector<br>- fight corruption<br>- reform judiciary<br>- design medium-term economic strategy<br>- diversify exports |

Source: Fink/Haiss (1999), derived from the financial sector in the EU Commission (1998) Progress Report.

**Table 1 continued**

| Country | Economic | Criteria | Acquis Criteria incl.EMU | Over-All Reform Priorities |
|---|---|---|---|---|
| Bulgaria | Bulgaria has advanced in the creation of a functio-ning market economy. The ability of the Bulgarian financial sector to fulfill the role of financial inter-mediation in the changed circumstances of the currency board remains unte-sted and cannot yet be assessed. Sustained reform efforts are necessary to esta-blish a regulatory and law enforcement framework that meets the needs of a market economy. | Banks are not fully playing their role of financial interme-diation. Due to the lack of market-oriented policies in the past, and in spite of its current progress, following the intro-duction of a currency board, Bulgaria would still face serious difficulties to cope with competitive pressure and market forces within the Uni-on in the medium term. | Bulgarias capacity to imple-ment and enforce the acquis is still weak. The lack of credit register for banks, licensing of outward capital transactions and slow bank privatization are main constraints for mee-ting the single market requirements. EMU participa-tion as a non-participant in the Euro area would incur serious problems, but can eventually be envisaged if reforms conti-nue. | - complete trade & price liberalization<br>- **privatization of banking** and enterprise sectors<br>- improve productivity<br>- **improve efficiency of financial intermediation**<br>- adapt public administration<br>- stable fiscal policy<br>- **increase foreign involve-ment in banking sector** |
| Romania | Romania made very little progress in the creation of a market economy. Capital and land markets are not functio-ning well. Only a radical and sustained improvement in the overall macroeconomic condi-tions and the imposition of financial discipline throughout the economy will lead to a meaningful improvement in the situation of the financial sector. | Romanias capacity to cope with competitive pressure and market forces has worsened due to lack of structural re-forms. The non-respect by a large number of economic agents of their contractual obligations does not ensure a sound basis for economic activity. The growth of small and medium sized enterprises is stifled by the complexity of administrative rules and the absence of long-term capital and woking capital financing from banks. | While the legal framework was set up, little progress in setting up institutions re-sponsible for acquis imple-mentation. Supervision of the financial supervision is not independent and under-equipped. Romania has a long way to go before the country will be able to assume the obligations of membership. Participation in EMU as non-participant in the euro area could pose serious problems. | - macroeconomic stability<br>- **credibility in internati-onal financial markets**<br>- privatization and attracting FDI<br>- **financial sector**<br>- **financial discipline in public companies and entities**<br>- **corporate governance in banks**<br>- root out corruption<br>- **establish respect of contractual obligatins, including repayment of creditors**<br>- workings of the courts |
| | note: none of the applicants | today fully meets criteria | | |

**Table 1** continued; source: Fink/Haiss (1999), derived from the financial ector in the EU Commission (1998) Progress Report.

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